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# A Sovereign Wealth Turn

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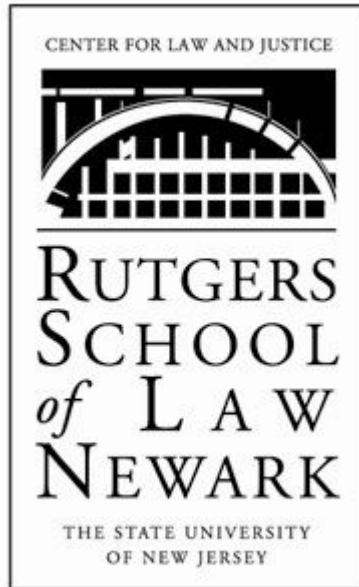
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A Sovereign Wealth Turn  
*Anna Gelpern*

**Rutgers School of Law Newark**

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## A Sovereign Wealth Turn

Anna Gelpern<sup>\*</sup>

### *I. Introduction: Enter GAPP*

The Generally Accepted Principles and Practices (GAPP) for sovereign wealth funds will debut at the annual meetings of the Bretton Woods institutions next month. The dry acronym evokes fading accounting conventions;<sup>1</sup> it belies the document's importance as a political and institutional milestone on the way to what might become international financial architecture. This is so even regardless of its contents, which at this writing remain to be revealed.

A working group of major sovereign wealth funds supported by the International Monetary Fund (IMF) negotiated GAPP, also called the Santiago Principles, over the summer.<sup>2</sup> If the principles succeed – if they target behavior that governments, markets, and people in home and host countries think important; if they are concrete enough to assess compliance; and if they do in fact prompt compliance with credible reputational sanctions or indirect enforcement – they will advance the project of financial integration, and recast the role of the IMF on the new financial landscape. If they fail, the failure will expose the challenges of integration more starkly, and reinforce doubts about the relevance of the twentieth-century institutional framework.

GAPP architects face a tall order because integration today goes beyond opening borders to trade and investment. It entails assimilating public capital in private markets on a vast scale, dealing with new forms of financial organization, and marrying financial systems

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<sup>\*</sup> Rutgers University School of Law—Newark. I am grateful to Tom Callaghy, Giselle Datz, Kevin Davis, Rashmi Dyal-Chand, Sky Julian, Brad Setser, Edwin M. Truman, and Matt Tubin for detailed comments on earlier drafts, to Kelly Targett for excellent research assistance, and to the Dean's Fund at Rutgers—Newark for financial support.

<sup>1</sup> Bob Davis, *Foreign Funds Agree to Set of Guiding Principles*, WALL STREET J., Sept. 3, 2008, at C1. See, e.g., Press Release No. 08/04, International Working Group of Sovereign Wealth Funds, International Working Group of Sovereign Wealth Funds Reaches a Preliminary Agreement on Draft Set *Generally Accepted Principles and Practices*—"Santiago Principles" (Sept. 2, 2008), available at <http://www.iwg-swf.org/pr/swfpr0804.htm>.

<sup>2</sup> See *id.*

premised on very different ideas about the role of the state in the economy. The task of governing global finance goes beyond rearranging the chairs and shares on the Bretton Woods decks, beyond getting the right Gs in the G-X, and beyond getting Basel right. It is about making coherent, legitimate, and accountable a patchwork of public laws, private codes, bureaucratic networks and institutional remnants left in last century's wake.<sup>3</sup> Sovereign wealth funds (SWFs) – pools of public money active in the private markets – uniquely embody the predicament.

This essay begins with an overview of the SWF controversy, then maps a four-part governance challenge for the funds. The GAPP exercise responds to this challenge. It brings together key new players in a policy coordination forum, and in a substantive, non-hierarchical relationship with the IMF. Countries that had played a limited role in shaping the norms of international finance have taken the lead writing the rules. In doing so, they have had to negotiate domestic and external demands, and reconcile very different visions of the state's role in the private markets. Time will tell whether this rare process achievement would alter the governance landscape in durable ways.

## *II. A Species in Context*

SWFs grew from a few million to nearly \$3 trillion in assets under management (not including state pension funds), surpassing hedge funds in just a few years, and projected to triple by 2013. This growth is part of a broader pattern of capital flows. For the past decade, states on the periphery saved, and states in the center spent at a growing pace. U.S. deficits ballooned while China, Russia and oil-producing states in the Middle East among others accumulated trillions of dollars from export revenues and keeping down the value of their currencies. The accumulation initially took the form of government purchases of U.S. Treasury and agency securities. Then came the surge in SWF investments in Europe and the United States, along with a surge in other overseas activity by non-traditional investors, such as China's state-owned enterprises and development

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<sup>3</sup> Kevin E. Davis, *Global Governance of Development Finance?* (Mar. 5, 2008) (unpublished manuscript on file with author).

agencies buying into African infrastructure and extraction. To date, SWFs have lagged far behind official foreign exchange reserves;<sup>4</sup> they are expected to overtake reserves in the next five years.<sup>5</sup>

Although the SWF form has existed for decades, the funds' recent growth<sup>6</sup> marks a qualitative shift in their role. SWFs are unlike traditional central bank reserves, because their investments are not limited to liquid, low-risk securities. They are unlike traditional state-owned enterprises because they do not normally operate their investment targets; most claim to seek passive portfolio investment. About forty states have SWFs; two-thirds are less than ten years old.<sup>7</sup> Some, such as Singapore's venerable Temasek, Norway's Government Pension Fund-Global, and the brand new China Investment Corporation (CIC), are in the news every day. Others like Botswana's Pula Fund are rarely mentioned.<sup>8</sup> Most of the older funds are from small, rich states in Asia and the Middle East, such as Singapore and Abu Dhabi; newer ones tend to come from larger, poorer states like China and Russia.<sup>9</sup>

When writing about SWFs, it is *de rigueur* to highlight their diversity: some are formed to offset commodity price swings, some save for future generations, others are essentially pension funds, yet others are simply out to make a buck. This makes for very different policy constraints, funding and investment profiles. The diversity is relevant in two

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<sup>4</sup> BRAD W. SETSER, COUNCIL ON FOREIGN RELATIONS, SOVEREIGN WEALTH AND SOVEREIGN POWER 10 (2008), available at [http://www.cfr.org/publication/17074/sovereign\\_wealth\\_and\\_sovereign\\_power.html?breadcrumb=%2Fpublication%2Fby\\_type%2Fspecial\\_report](http://www.cfr.org/publication/17074/sovereign_wealth_and_sovereign_power.html?breadcrumb=%2Fpublication%2Fby_type%2Fspecial_report) [hereinafter "SETSER REPORT"]. See also Brad Setser, *It Is 2004 All Over Again: Central Banks Haven't Shifted Away from Safe, Liquid Assets*, BRAD SETSER: FOLLOW THE MONEY, <http://blogs.cfr.org/setser/2008/06/23/it-is-2004-all-over-again-central-banks-havent-shifted-away-from-safe-liquid-assets/#more-3615> (June 23, 2008, 11:06 a.m.).

<sup>5</sup> See John Lipsky, First Deputy Managing Director of the International Monetary Fund at the seminar, *Sovereign Funds: Responsibility with Our Future* organized by the Ministry of Finance of Chile (Sept. 3, 2008), text as prepared for delivery available at <http://www.imf.org/external/np/speeches/2008/090308.htm>.

<sup>6</sup> See *id.*

<sup>7</sup> See *id.*

<sup>8</sup> For a comparison of sovereign wealth funds including the Pula Fund, see Edwin M. Truman, *A Blueprint for Sovereign Wealth Fund Best Practices*, Policy Brief (Peterson Institute for International Economics), Apr. 2008, available at <http://www.petersoninstitute.org/publications/pb/pb08-3.pdf>.

<sup>9</sup> See SETSER REPORT, *supra* note 4, at 7. See also Brad Setser, *China Buys, Norway Sells*, BRAD SETSER: FOLLOW THE MONEY, <http://blogs.cfr.org/setser/2008/09/09/china-buys-norway-sells/> (Sept. 9, 2008, 10:20 p.m.).

ways. First, the funds may find it difficult to coordinate among themselves. Second, it is hard to devise a unified policy fix for something that is not a unified phenomenon. But it is the basic features shared by most SWFs that have excited the public and academic interest: they are huge, they are controlled by governments, and they play in markets where governments had not played before on a large scale, most notably, equity.<sup>10</sup> SWFs' size makes them important. Sovereign control raises the specter of political intervention, and may make it easier for the funds to change form, objective, and investment strategy: profit will drive them ... until it does not. SWFs' appearance on new turf tests the adequacy of regulation and market structures.

Public debate about SWFs began in earnest in 2007, and it began badly. In the United States, SWF acquisitions came on the heels of mishandled attempts by state-owned companies (not SWFs) from China and the Persian Gulf to buy into U.S. oil and port facilities, and roughly coincided with the start of the credit crisis.<sup>11</sup> Nevertheless, SWFs hit a raw nerve because they represented all the scary news at once: the color-coded security alerts, Wall Street's desperate hunt for capital, the failure of regulation, the decline of 20<sup>th</sup> century international institutions, and massive concentration of wealth in the hands of not-necessarily democratic, not-entirely capitalist, and not-altogether friendly governments. Calls for severe investment restrictions came naturally, framed in terms of sovereignty and national security.<sup>12</sup> The equally predictable protests against protectionism followed.<sup>13</sup> Two years later, policy middle ground was well-settled. New

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<sup>10</sup> But note that to date, SWF equity investments have been relatively small, while reserve investments in equity becoming more common. *See, e.g.,* WILLIAM MIRACKY ET AL., ASSESSING THE RISKS: THE BEHAVIORS OF SOVEREIGN WEALTH FUNDS IN THE GLOBAL ECONOMY 7 (June 2008), available at [http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor\\_SWF\\_report\\_final.pdf](http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor_SWF_report_final.pdf) (noting that in 2007, SWFs invested \$92 billion in equity transactions); SETSER REPORT, *supra* note 4, at \_\_ (noting that an official survey in 2007 "revised Chinese debt purchases up by about \$70 billion, and official purchase of debt up by \$100 billion. Counting equities, Chinese purchases were revised up by close to \$90 billion and total official purchases by around \$130 billion.")

<sup>11</sup> Katharina Pistor, *Global Network Finance* 2-8 (Am. Law & Econ. Ass'n. 18th Annual Meeting, Working Paper No. 54, 2008), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=2611&context=alea>.

<sup>12</sup> Evan Bayh, *Time for Sovereign Wealth Rules*, WALL STREET J., Feb. 13, 2008, at A26.

<sup>13</sup> DAVID M. MARCHICK & MATTHEW J. SLAUGHTER, COUNCIL ON FOREIGN RELATIONS, GLOBAL FDI POLICY: CORRECTING A PROTECTIONIST DRIFT 10 (2008), available at <http://www.cfr.org/publication/16503/>.

law made minor tweaks to the open investment framework established in the 1980s,<sup>14</sup> while U.S. officials preached transparency and made SWFs promise to act commercially.<sup>15</sup> The United States was not alone: other hosts went through similar debates.<sup>16</sup>

Law reform did not lay controversy to rest. SWFs turned out to be bigger than the national security-open investment quarrel that had trapped them. They came to embody the power shifts and culture clashes of financial integration, which, thanks to capital flow reversals, no longer looked like a simple exercise to reshape the world in the Anglo-American image.

### *III. Serving Many Masters*

Governing SWFs – and being governed by them – must begin by understanding to whom they answer, deciding to whom they should answer, and finding a way to resolve the inevitable conflicts among SWFs’ constituencies at home and abroad. SWFs as a group are a jumble of contradictions and a heap of new paradigms: public money that pledges to act as if it were private, vast pools of capital that promise not to move markets, non-controlling investors that run centrally controlled economies; and public fiduciaries that balk at corporate governance of their investment targets.

SWFs are not unique for juggling conflicting demands. Public-private hybrids like government-sponsored enterprises (for example, Fannie Mae, R.I.P. 1968-2008) must

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<sup>14</sup> Foreign Investment and National Security Act of 2007 (“FINSA”), Pub. L. No. 110-49, 121 Stat. 246 (2007) (amending § 721 of the Defense Production Act of 1950 (“DPA”)). The amendment included stricter requirements for state-controlled investments.

<sup>15</sup> See e.g., Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFFAIRS (Jan./Feb. 2008), available at <http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html> [hereinafter “Kimmitt *Public Footprints*”]; Clay Lowery, U.S. Dept. of the Treasury Assistant Secretary for International Affairs, *The Role of Sovereign Wealth Funds in the Global Economy*, Remarks at Barclays Capital’s 12th Annual Global Inflation-Linked Conference (Feb. 12, 2008), available at <http://www.ustreas.gov/press/releases/hp836.htm>; U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS, U.S. FACT SHEET: FOURTH CABINET-LEVEL MEETING OF THE U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE 2-3 (June 18, 2008), available at <http://www.treas.gov/press/releases/reports/sedusfactsheet.pdf>.

<sup>16</sup> MARCHICK & SLAUGHTER, *supra* note 13, at 7-12.

reconcile duties to their shareholders with duties to the public.<sup>17</sup> Transnational hybrids, such as SWFs, have another dimension with which to contend: they must answer to constituencies both at home and abroad.<sup>18</sup> In all, SWFs face a four-fold accountability challenge.

First, there is *public internal accountability*, which must be achieved within the political system of the capital-exporting state. As government institutions, SWFs must further domestic public purpose. The state may be democratic, in which case SWFs answer to elected officials, or not, in which case they might answer to the monarch and her five cousins. China's CIC, established in September 2007 with \$200 billion from central bank reserves, reports directly to the State Council. Its board is made up of officials from powerful government agencies.<sup>19</sup> CIC appears to have at least two public missions: to reform the Chinese banking sector and to boost returns on foreign exchange reserves.<sup>20</sup> Influential observers in the Chinese press debate other public goals, including fiscal stabilization and growing export markets.<sup>21</sup> Each potentially implies a very different investment strategy; reconciling them is a matter for the Chinese political system, with critical implications for the rest of the world.<sup>22</sup>

<sup>17</sup> See A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 562-574 (1995).

<sup>18</sup> See Ashby H.B. Monk, *Recasting the Sovereign Wealth Fund Debate: Organizational Legitimacy, Institutional Governance and Geopolitics* 4-6 (Centre for Employment, Work & Finance, Oxford University Centre for the Environment Working Paper, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1134862](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862).

<sup>19</sup> Brad W. Setser, *What to Do With Over Half a Trillion a Year? Understanding the Changes in the Management of China's Foreign Assets*, RGE MONITOR, Jan. 18, 2008, available at [http://www.cfr.org/publication/15294/what\\_to\\_do\\_with\\_over\\_a\\_half\\_a\\_trillion\\_a\\_year\\_understanding\\_the\\_changes\\_in\\_the\\_management\\_of\\_chinas\\_foreign\\_assets.html?breadcrumb=%2Fbios%2F8937%2FBrad\\_w\\_setser%3Fgroupby%3D3%26hide%3D1%26id%3D8937%26filter%3D2008](http://www.cfr.org/publication/15294/what_to_do_with_over_a_half_a_trillion_a_year_understanding_the_changes_in_the_management_of_chinas_foreign_assets.html?breadcrumb=%2Fbios%2F8937%2FBrad_w_setser%3Fgroupby%3D3%26hide%3D1%26id%3D8937%26filter%3D2008); see also MICHAEL F. MARTIN, CRS REPORT FOR CONGRESS: CHINA'S SOVEREIGN WEALTH FUND 26 (2008), available at <http://www.fas.org/sgp/crs/row/RL34337.pdf>.

<sup>20</sup> China's state-owned bank holding company was recently made a subsidiary of CIC, further confusing the mission. ChinaStakes.com, *A Simmering CIC-Huijin Separation*, July 8, 2008, <http://www.chinastakes.com/story.aspx?id=495> (last visited Sept. 14, 2008).

<sup>21</sup> Ashby H.B. Monk, Scott Moore & Xunyi 'Jane' Xu, *A Review of Chinese Language Literature on Sovereign Wealth Funds* 11-12 (Oxford International Review Sovereign Wealth Funds Team Working Paper No. SWF001, 2008), available at <http://oxfordir.files.wordpress.com/2008/07/swf001.pdf>.

<sup>22</sup> Recent administrative restructuring brought a number of Chinese banks under CIC control. This raised prudential concerns in the United States when several of the banks sought to establish operations in New York. Scott G. Alvarez, General Counsel for the Board of Governors of the Federal Reserve System, Testimony Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises,



Second, *private internal accountability* refers to SWFs' duties to narrower constituencies, such as shareholders, derived from their charters. Public and private internal accountability may conflict where, for example, a fund established to save for old age is used to advance unrelated strategic goals.<sup>23</sup> Transparency can expose internal accountability tensions. A transparent SWF seeking to maximize return on investment may have to forego opportunities in politically unpopular sectors or countries to secure domestic legitimacy.<sup>24</sup>

Third, *public external accountability* implies a duty of state-owned funds to adhere to international norms. Acting as a market participant should not absolve the state of its basic public duties:<sup>25</sup> for example, not to fund genocide. Norwegian officials point to public international norms, such as the U.N. Global Compact, as well as domestic procedural safeguards, to defend their SWF's ethical guidelines and its shunning of Wal-Mart.<sup>26</sup>

But how far does this duty to the system run? When observers extol SWFs' role as "patient capital" serving financial stability, does it follow that SWFs must refrain from aggressive trading? When the United States asks China to invest commercially,<sup>27</sup> does it expect CIC to hold U.S. financial stocks in a credit crunch? Iceland thought so when it caught Norway short-selling its bank shares in 2006.<sup>28</sup> Here too transparency is a bone of contention: failure to disclose SWF positions can impede macroeconomic surveillance

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Committee on Financial Services, U.S. House of Representatives (Mar. 5, 2008), *available at* <http://www.federalreserve.gov/newsevents/testimony/alvarez20080305a.htm>; Jamil Anderlini & Geoff Dyer, *US Delays Licenses to Top Chinese Banks*, FT.com, Jun. 16, 2008, *available at* <http://www.ft.com/cms/s/0/4dc9a06c-3bcb-11dd-9cb2-0000779fd2ac.html> (last visited Sept. 17, 2008).

<sup>23</sup> In what is likely a more common scenario, Norway's SWF has financed the government beyond the limits established by its internal guidelines. Truman, *supra* note 8, at 9.

<sup>24</sup> Steven Schwarzman, *Reject Sovereign Wealth Funds at Your Peril*, FT.com, Jun. 20, 2008, *available at* <http://www.ft.com/cms/s/0/405b8888-3dff-11dd-b16d-0000779fd2ac.html> (last visited Sept. 16, 2008).

<sup>25</sup> Cf. *Lebron v. Nat'l R. R. Passenger Corp.*, 513 U.S. 374 (1995) (making a similar argument in the U.S. domestic context).

<sup>26</sup> Kristin Halvorsen, Norwegian Minister of Finance, speech at the 2008 OECD Forum on Climate Change, Growth, Stability, *Sovereign Wealth Funds* (June 3-4, 2008), *transcript available at* <http://www.oecd.org/dataoecd/24/57/40760305.pdf>, at 2-3.

<sup>27</sup> See *supra* note 15. Similar agreements were reached with Singapore and Abu Dhabi.

<sup>28</sup> *Asset-Backed Insecurity*, THE ECONOMIST, Jan. 17, 2008, at 386, *available at* [http://www.economist.com/finance/displaystory.cfm?story\\_id=10533428](http://www.economist.com/finance/displaystory.cfm?story_id=10533428).

and potentially unsettle the markets; disclosure can put SWFs at a disadvantage to wholly private competitors, such as hedge funds, and other SWFs.<sup>29</sup>

Fourth, *private external accountability* refers to SWFs' duties as creditors and shareholders, which they may owe their investment targets under host country laws. For the most part, SWFs are already bound by these laws simply by virtue of the investment: for example, they may not engage in insider trading or self-dealing. The worry is that SWFs might simply flout the laws when it becomes expedient, on the assumption that being sovereign, they can escape sanction. In this context, extracting SWF promises to abide by the laws<sup>30</sup> seems feckless: such promises hardly solve the underlying commitment problem. Proposals to deprive SWFs of shareholder voting rights<sup>31</sup> do address commitment, but may have little practical impact: votes matter less when you can phone the CEO, or when all else fails, the Finance Minister. Governments' capacity to exert influence and get information through private channels is a central concern with sovereign investments; modifying formal voting rules avoids the issue. The normative assumptions behind voting proposals also merit a closer look. Is disenfranchising public shareholders (and thereby empowering the rest) good for corporate governance? Does it serve government accountability in the home country? More cynically, is depriving Russia of a formal shareholder vote worth giving up Norway's or California pension funds' leverage on human rights?

This four-part typology is simplified. It is also descriptive. Reconciling tensions among the four basic categories requires agreement on norms.

#### IV. *After MAI, Beyond CFIUS, the IMF Rides Again?*

A year ago, there was no obvious forum to negotiate norms to govern SWFs. Domestic debates in host states were stuck in the sovereignty-protectionism rut. With its power to

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<sup>29</sup> Press Conference Call Transcript No. 08/01, International Working group of Sovereign Wealth Funds (Sept. 2, 2008), available at <http://www.iwg-swf.org/tr.htm>; see also Halvorsen, *supra* note 26, at 1-2.

<sup>30</sup> See Lowery, *supra* note 15; Kimmett *Public Footprints*, *supra* note 15.

<sup>31</sup> Ronald J. Gilson & Curtis J. Milhaupt, 60 STAN. L. REV. 1345, 1352 (2008), available at <http://lawreview.stanford.edu/content/vol60/issue5/GilsonMilhaupt.pdf>.

block transactions that threaten national security, the Committee on Foreign Investment in the United States (CFIUS) had gone from obscurity to celebrity, became an emblem of the controversy over sovereign investment, and inspired imitators around the world.<sup>32</sup> SWF sponsors saw this trend as both an economic and a political threat. To the people at home, SWFs stood for economic security, political autonomy and global prestige. Even in states where the masses had little knowledge and no influence over how public money was invested, governments could lose face by making too many concessions to host country fears.

The leading broker of international investment norms, the Organization for Economic Cooperation and Development (OECD), had not recovered global credibility after the failure of its Multilateral Agreement on Investment (MAI) in the 1990s.<sup>33</sup> Back then, the OECD faced criticism as an exclusive club dominated by wealthy capital exporters in Europe and North America. In an ironic turn, it is now formulating best practices for hosting SWFs.<sup>34</sup>

The IMF was both a natural and an unlikely alternative candidate to come up with norms to govern SWFs. Its macroeconomic and financial stability expertise made the IMF uniquely credible in addressing issues of deep concern to home and host states alike. It knew all the actors involved<sup>35</sup> and had analyzed the advent of SWFs for some time.<sup>36</sup> Unlike the OECD, the Fund's membership is nearly universal, though its internal governance remains controversial even after a round of reforms to give more voice to the

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<sup>32</sup> A description of CFIUS authority and activities is available on the website for the United States Department of the Treasury. Committee on Foreign Investment in the United States (CFIUS), <http://www.ustreas.gov/offices/international-affairs/cfius/> (last visited Sept. 16, 2008).

<sup>33</sup> Attempts to revive multilateral investment negotiations at the World Trade Organization after MAI's collapse also failed.

<sup>34</sup> Press Release, Organisation for Economic Co-Operation and Development, OECD Countries Stay Open to Commercial Investments by Sovereign Wealth Funds (Sept. 4, 2008), *available at* [http://www.oecd.org/document/9/0,3343,en\\_2649\\_201185\\_40409737\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/9/0,3343,en_2649_201185_40409737_1_1_1_1,00.html).

<sup>35</sup> NGAIRE WOODS, *THE GLOBALIZERS: THE IMF, THE WORLD BANK AND THEIR BORROWERS* 4 (2006) (linking the IMF's policy influence and its long-standing relationships with world governments).

<sup>36</sup> *See, e.g., generally*, INTERNATIONAL MONETARY FUND, *GLOBAL FINANCIAL STABILITY REPORT* (Apr. 2007).

erstwhile periphery.<sup>37</sup> The IMF has jurisdiction over its members' exchange rate policies, current account convertibility, and broad macroeconomic and financial policy responsibility. However, its authority over capital flows, including investment, is partial, ambiguous, and worse for wear since the capital account crises of the 1990s and early 2000s.<sup>38</sup> The Fund's recent track record with policy surveillance has been mixed at best.<sup>39</sup> It did little to reduce the imbalances that spawned the new wave of SWFs: it could no more influence U.S. tax policy than China's exchange rate management.

In a compromise, the IMF got tagged at its 2007 Annual Meetings to help leading SWFs distill "best practices" for going about their business.<sup>40</sup> Prodded by the G-7, the IMF envisaged something along the lines of its prior forays into best practices for fiscal transparency and reserve management.<sup>41</sup> Yet the new project was quite different. The IMF did not come to the table with authority to determine the standards, assess compliance, or sanction noncompliance, with the result. It dealt with states that by definition did not need its money and were unlikely to need it in the foreseeable future. The IMF's functions were expert, convening, and secretarial. The output was emphatically voluntary;<sup>42</sup> it may not even rate as soft law.<sup>43</sup> Meanwhile, reports on SWFs' enthusiasm for the exercise were not encouraging. Soon after receiving the assignment, one IMF official observed that the "best" in "best practices" was too controversial. He was right – to a point.

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<sup>37</sup> Press Release, International Monetary Fund, Directors Back Reforms to Overhaul IMF Quotas and Voice (Mar. 28, 2008), available at <http://www.imf.org/external/pubs/ft/survey/so/2008/NEW032808A.htm>.

<sup>38</sup> See e.g., INTERNATIONAL MONETARY FUND INDEPENDENT EVALUATION OFFICE, THE IMF'S APPROACH TO CAPITAL ACCOUNT LIBERALIZATION 3 (2005) available at <http://www.imo-imf.org/eval/complete/pdf/04202005/report.pdf>.

<sup>39</sup> BUREAU OF INT'L AFFAIRS, U.S. DEPT. OF THE TREASURY, REPORT TO CONGRESS ON IMPLEMENTATION OF THE INTERNATIONAL MONETARY FUND'S 2007 DECISION OF SURVEILLANCE OVER MEMBERS' POLICIES 2 (2008), available at <http://www.ustreas.gov/press/releases/reports/82808report.pdf>. (stating that the IMF's "implementation of the new decision can be viewed as mixed.").

<sup>40</sup> Press Release No. 08/78, International Monetary Fund, Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund (Apr. 12, 2008), available at <http://www.imf.org/external/np/sec/pr/2008/pr0878.htm>.

<sup>41</sup> INTERNATIONAL MONETARY FUND, SOVEREIGN WEALTH FUNDS—A WORK AGENDA 22 (Feb. 29, 2008) available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>.

<sup>42</sup> See Press Conference Call Transcript, *supra* note 29.

<sup>43</sup> For a description of soft law, see Dinah Shelton, Normative Hierarchy in International Law, 100 AM. J. INT'L L 291, 319-22 (2006).

V. *Behind the New Acronyms*

An International Working Group (IWG) made up of two dozen or so state with SWFs<sup>44</sup> negotiated GAPP between May and September 2008. They met three times, in Washington, Singapore and Chile, with a drafting session in Norway. The group was chaired by two senior officials, one from the world's largest SWF, the Abu Dhabi Investment Authority, and another from the IMF. Several home and host countries, along with representatives of the OECD, the World Bank, and the European Union, attended IWG meetings as observers. The agreement was announced at the meeting in Santiago on September 2, 2008. The Santiago Principles did not claim to be the "best," but they did aspire to be "generally accepted" by home and host constituencies.<sup>45</sup> IWG member governments are expected to sign off on the Santiago text before October 11, when it would be presented to the IMF's policy-setting International Monetary and Financial Committee (IMFC) and the general IMF membership.<sup>46</sup> A ritual welcome will follow.

What is known about GAPP's scope and structure puts the principles in the analytical mainstream, but says little about the underlying norms and politics. Speeches and press statements surrounding the IWG announcement reveal concern with SWFs' place in home countries' policy mix, a shared sense of their public role in promoting financial stability, and recognition that SWFs' decision-making is poorly understood and worrisome to hosts – but also suspicion on the part of many funds that they operate on hostile, unfamiliar turf that may tilt in favor of private and public competitors. The IWG product wants to reassure, but not at the expense of losing autonomy or competitive edge.

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<sup>44</sup> According to the IWG website,

The IWG member countries are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank, participate as permanent observers.

Press Release No. 08/04, *supra* note 1.

<sup>45</sup> [Cf. the Generally Accepted Accounting Principles in the United States, except that they are giving way to International Accounting Standards.]

<sup>46</sup> Press Conference Call Transcript, *supra* note 29.

The two dozen principles address the structure and objectives of SWFs (“legal, institutional and macroeconomic” factors), their governance and accountability arrangements (especially decision autonomy from the home government) and their investment and risk management policies, focusing on financial stability.<sup>47</sup> This framing is broadly in line with earlier pronouncements by the G-7, and consistent with the comprehensive “Blueprint for SWF Best Practices” proposed by Edwin M. Truman at the Peterson Institute.<sup>48</sup> Detailed comparisons will be illuminating.

The Blueprint and the accompanying scoreboard are rare in the SWF literature for stressing accountability in home and host countries alike. They use a four-pronged assessment of Structure, Governance, Transparency and Accountability, and Behavior. For all four prongs, the principal device to achieve accountability is disclosure; arm’s length dealing is another recurring theme. While the need for accountability is universal, the use of disclosure and arm’s length dealing to achieve it is less so. As a matter of public internal accountability, some systems might prefer substantive regulation (specific approval of investments or prohibition of bad practices); yet others would focus on procedural safeguards and administrative controls. Internal accountability may also argue against separating politics from arm’s length commerce.<sup>49</sup> It is certainly plausible to argue that disclosure is the better way to satisfy both internal and external accountability demands; it has been gaining strength as a norm in the international financial system.<sup>50</sup> But as Truman points out, many SWF governments were not involved in designing the system and believe, along with their citizens, that they have no

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<sup>47</sup> *Id.*

<sup>48</sup> Truman, *supra* note 8. The Blueprint includes public pension funds in the definition of SWFs. These generally score better than non-pension SWFs (although some non-pension SWFs score equally well). It is possible that pension funds enjoy a greater public perception as “other people’s money” – funds belonging to a defined constituency, rather than taxpayers at large – that entails a higher burden of accountability to the owners.

<sup>49</sup> See, generally, Monk et al., *supra* note 21 (discussing debates in China).

<sup>50</sup> See Press Release, *supra* note 37; International Monetary Fund Legal Department, *Selected Decisions and Selected Documents of the IMF, Thirtieth Issue—Summing Up by the Acting Chairman—Standards for the Dissemination of Economic and Financial Statistics to the Public by Member Countries and Implementation of the SDDS [Special Data Dissemination Standard]* (2006), <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=EBM/96/36>, (arguing that “comprehensive economic and financial data, disseminated on a timely basis, are essential to the transparency of macroeconomic performance and policy.”).

stake in it.<sup>51</sup> The Santiago Principles will expose the extent to which the new players buy into the system's way of achieving accountability, or try to bring global norms more in line with their domestic norms.

Implementation will be similarly revealing. When IWG announced agreement on the Santiago Principles, its members were at pains to disassociate them from the IMF surveillance process: they insisted that everything about the principles was voluntary. Perhaps as a matter of preemption, the Santiago Principles incorporate a periodic internal review mechanism.<sup>52</sup> In theory, nothing prevents the IMF from considering GAPP criteria in its assessment of home and host policies implicating SWFs, just as nothing prevents a host government from using GAPP as part of its investment screen. But doing so may undermine the Santiago Principles' legitimacy in the home countries, and scuttle cooperation between new and old powers and institutions.

In all, the final product contains elements of several established species: best practices produced by and for the public sector (for example, IMF on fiscal transparency), corporate codes of conduct produced by the private sector to regulate itself, and principles jointly produced by public and private actors to regulate private conduct (for example, the Equator Principles, a collaboration between private banks and the International Finance Corporation). GAPP would be unusual because the principles are produced by and for public entities, yet they purport to regulate market activity.<sup>53</sup> Since reaching agreement on the principles, IWG has released a SWF survey, answering calls for transparency while seizing initiative and asserting control in a field where

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<sup>51</sup> Edwin M. Truman, Testimony Before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, U.S. House of Representatives 6 (Sept. 10, 2008) [hereinafter "Truman Testimony"] available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/truman091008.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/truman091008.pdf).

<sup>52</sup> Press Conference Call Transcript, *supra* note 29.

<sup>53</sup> Compare INSTITUTE OF INT'L FINANCE, INC., PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS (2005), available at <http://www.iif.com/download.php?id=4fyB5BGIKzU>.

authoritative information is scarce and getting more so.<sup>54</sup> Governments as market actors<sup>55</sup> seem to favor self-regulation.

Among the most interesting aspects of the IWG exercise is the group's decision to stick around. SWFs that had started as reluctant participants "agreed to explore the creation of a standing group" to provide ongoing review of the Santiago Principles. Such a standing group could naturally become a forum for policy coordination, although it is hard to predict its remit. Because of the SWFs' hybrid character, the potential models range from the G-7 (monetary policy) to OPEC (a producers' cartel). Regardless of the model, any new body would coordinate with the IMF, the various Gs and regional groupings.

It bodes well for IWG's future that its efforts on GAPP have outstripped the OECD's work with SWF hosts. Competing funds that have never worked together before managed to come up with what appears to be a detailed, operational code of conduct in a matter of months. To date, the OECD – an organization of mainly wealthy states that have worked together for decades – has produced general guidelines grounded in its existing instruments; best practices will come in 2009.<sup>56</sup> The interim product has little operational guidance for host authorities, and does not appear to have constrained them.<sup>57</sup>

SWF and other sovereign investments raise many complex regulatory questions for the hosts: should governments be allowed to vote their stock like private shareholders?<sup>58</sup> Should SWFs enjoy tax breaks for governments?<sup>59</sup> Can national securities regulators

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<sup>54</sup> Sovereign Wealth Funds: Current Institutional and Operational Practices (Sep. 15, 2008), available at <http://iwg-swf.org/pubs/swfsurvey.pdf>. SETSER REPORT, *supra* note 4, at 40 (noting a decline in transparency).

<sup>55</sup> See, generally, Giselle Datz, Governments as Market Players: New Forms of State Competition, Adaptation and Innovation in the Global Economy (Oct. 2007) (unpublished manuscript, on file with author); Eric Helleiner & Troy Lundblad, *States Markets and Sovereign Wealth Funds*, GERMAN POLICY STUDIES (forthcoming Fall 2008).

<sup>56</sup> See Letter from Angel Gurría, OECD Secretary-General, to G7 Finance Ministers, (Apr. 4, 2008), with accompanying report of the OECD INVESTMENT COMMITTEE, SOVEREIGN WEALTH FUNDS AND RECIPIENT COUNTRY POLICIES 6 (Apr. 4, 2008), available at <http://www.oecd.org/dataoecd/34/9/40408735.pdf>.

<sup>57</sup> Truman Testimony, *supra* note 51, at 16-18.

<sup>58</sup> Gilson & Milhaupt, *supra* note 31, at [10-11].

<sup>59</sup> Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. Rev. (forthcoming 2009).



adequately discipline states for offenses such as insider trading?<sup>60</sup> Should bank-owning SWFs be subject to supervision and activities restrictions to safeguard national banking systems and deposit insurance schemes?<sup>61</sup> The OECD may or may not be the best forum to coordinate approaches to these issues, but for now, the answers will surface ad-hoc.

## VI. *Conclusion: Why It Matters*

In 1952, the top lawyer at the State Department informed his counterpart at the Justice Department that the United States would no longer support sovereign claims of absolute immunity in U.S. court cases involving commercial activity by another state. The law was keeping pace with the international economy:

[L]ittle support has been found except on the part of the Soviet Union and its satellites for continued full acceptance of the absolute theory of sovereign immunity. ... The reasons which obviously motivate state trading countries in adhering to the theory with perhaps increasing rigidity are most persuasive that the United States should change its policy. ... [T]he department feels that the widespread and increasing practice on the part of governments engaging in commercial activities makes necessary a practice which will enable persons doing business with them to have their rights determined in the courts.<sup>62</sup>

The United States was responding to state-owned commerce from the Soviet bloc.

Operating “not as a regulator of a market, but in the manner of a private player within it”<sup>63</sup> exposed states to lawsuits in U.S. federal courts.

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<sup>60</sup> Chairman Christopher Cox, Chairman of U.S. Securities and Exchange Commission, Keynote Address and Robert B. Glauber Lecture at the John F. Kennedy School of Government, Harvard University, entitled *The Role of Governments in Markets* (Oct. 24, 2007), at Schedule B, available at <http://www.sec.gov/news/speech/2007/spch102407cc.htm>.

<sup>61</sup> Alvarez, *supra* note 22. A Chinese state-owned holding company that owns two Chinese banks was transferred to the China Investment Corporation, a SWF, as a result of an internal reorganization. The banks are seeing to establish a U.S. presence. The U.S. Federal Reserve argues that the reorganization should subject the SWF to the strictures of the U.S. Bank Holding Company Act, which could severely restrict the Fund’s activities. Anderlini & Dyer, *supra* note 22. Conditional approval has since been granted.

<sup>62</sup> Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman (May 19, 1952), reprinted in 26 DEP’T STATE BULL 984, 984–85 (1952).

<sup>63</sup> Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 614 (1992). However, an activity that may be private for foreign sovereign immunity purposes may be public in other areas of the law: Argentina’s market borrowing is patently commercial; Kentucky’s is “quintessentially public”. Dept. of Revenue of Ky. v. Davis, 128 S. Ct. 1801, 1810 (2008). Identity matters.

The commercial activity exception to sovereign immunity was from the start a way of mediating U.S. interaction with countries that held different views of the state's role in the economy. But because the dominant mode of interaction between the United States and the Soviet Union in 1952 was trade, the way the Soviets organized their internal affairs was unimportant – the new exception to sovereign immunity would help level the playing field for U.S. firms, not manage their acquisition by the Soviet state.

Fifty years later, with a new wave of large-scale sovereign investment, hereto irrelevant details of how other states run their economies have become critical. Conflicting accountability demands arise more often and in more legal fields, including corporate, banking, tax and securities. To rephrase Justice Scalia, SWFs operate *both* as regulators of the market and as private players within it.<sup>64</sup> The concern goes far beyond SWFs, whose investment strategies have been largely passive to date.<sup>65</sup> Outsize debt holdings by foreign central banks, notably China's,<sup>66</sup> and infrastructure acquisitions by state-owned enterprises, notably Russia's,<sup>67</sup> reveal a new level of interdependence among systems that have little in common otherwise. Brazil, China, Norway, Qatar and the United States mix public and private in different ways. When their hybrids go global, they reshape the law and structure of global finance.<sup>68</sup>

The Santiago project may be a preview of this structure. It may help establish a new role for the IMF in financial diplomacy: a shift from the hard power of conditionality in the 20<sup>th</sup> century to the soft power of persuasion and expertise in the 21<sup>st</sup>. In the world of soft power, brokering compromise on sovereign investment is a big step up from technical assistance. IWG may launch a new policy coordination regime among key actors who had trouble taking center stage in the 20<sup>th</sup> century institutional framework. Ad-hoc,

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<sup>64</sup> *Weltover*, 504 U.S. at 614; *see* Datz *supra* note 55 for examples.

<sup>65</sup> Setser argues SWFs are a distraction. SETSER REPORT, *supra* note 4, at 10.

<sup>66</sup> Cf. Jamil Anderlini, *Beijing Uses Forex Reserves to Target Taiwan*, FT.com, Sept. 11, 2008, available at <http://www.ft.com/cms/s/0/22fe798e-802c-11dd-99a9-000077b07658.html>, (last visited Sept. 21, 2008).

<sup>67</sup> Richard Wachman, *Gazprom Seeks to Build Empire Via European Utilities Stakes*, THE OBSERVER, Jan. 28, 2007, at 2, available at <http://www.guardian.co.uk/business/2007/jan/28/russia>.

<sup>68</sup> Helleiner & Lundblad, *supra* note 55.

interest-based groupings such as the IWG or its successor, horizontally linked with established institutions such as the IMF, may chip away at standing general fora such as the G-7, which seemed to run the institutions. It is ironic that if GAPP works, it could both bolster the old institutional center with a new mission for the IMF, and validate new, softer, more plural regulation with voluntary principles issued by an ad-hoc body.

Just as easily, the Santiago Principles could fail. They may turn out to be too vague or too stingy to reassure the hosts, or too restrictive to bind a set of very diverse and very rich actors whose interests often conflict. More likely, if the principles succeed at fostering model corporate governance and transparency in SWFs, the (still-hypothetical) threats that prompted GAPP may assume different form – shifting out of SWFs into reserve pools, state-owned enterprises, or new vehicles as yet unknown. The GAPP model would still be out there, but it would apply to an unimportant fringe of sovereign finance.

It will be tempting to see GAPP as an exercise in technocratic legitimation – producing dry, technical rules to help Chinese, Russian and Arab money look friendlier to their U.S. and European hosts, while maintaining the mandate to invest from the masses at home.<sup>69</sup> This undersells the achievement. Whatever the outcome, GAPP implicates core substantive issues and uses SWFs as catalysts to negotiate the terms of integration and governance among different political, social and economic systems – Saudi Arabia, Brazil, China and Norway, and their hosts in the United States, Europe and Africa.

SWFs are neither good nor bad. They may even turn out to be unimportant. But they are a sign of things to come. International legal and financial systems need the capacity to adjust accordingly.

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<sup>69</sup> Monk, *supra* note 18 at 4-6.